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No. 76

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In the Supreme Court of the United States

OCTOBER TERM, 1952

EDWIN E. HEALY AND GORDON W. HARTEFIELD,
PETITIONERS

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE COMMISSIONER

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v.

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 9-13) are reported at 16 T. C. 200. The opinion of the Court of Appeals (R. 15-17) is reported at 194 F. 2d 662.

JURISDICTION

The judgments of the Court of Appeals were entered on February 15, 1952. (R. 18-19.) The petition for a writ of certiorari was filed on May 20, 1952, within the extended time allowed by order

dated May 12, 1952 (R. 20), and was granted on October 13, 1952 (R. 21). The jurisdiction of this Court rests upon 28 U.S.C., Section 1254.

QUESTION PRESENTED

In 1945 taxpayers each received a salary of \$30,000 from an insolvent corporation owned by them. Each reported the full amount in his individual income tax return for 1945 and the corporation in its 1945 return claimed deductions for both salary payments. The Commissioner in a subsequent year determined that the salaries were in excess of reasonable compensation, and taxpayers, having become subject to transferee liability, each paid a total of \$5,681.03 on tax deficiencies of the corporation for prior years. May taxpayers' individual 1945 tax liabilities be recomputed by excluding such payments from their income for that year?

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—“Gross income” includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the trans-

action of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

* * * *

(26 U.S.C. 1946 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) [as amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687] *General Rule.* —The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts

are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 42.)

SEC. 311. TRANSFERRED ASSETS.

(a) *Method of Collection.*—The amounts of the following liabilities shall, except as herein-after in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter * * *:

(1) *Transferees.*—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

* * * * *

(26 U.S.C. 1946 ed., Sec. 311.)

STATEMENT

The facts, all of which were stipulated, were found by the Tax Court as stipulated (R. 9) and may be summarized as follows:

Taxpayer Edwin E. Healy was president of the Hartfield-Healy Supply Company, Inc., a New York corporation, and taxpayer Gordon W. Hartfield was vice-president and treasurer of the corporation. Each owned 25 of the total of 52 shares of the corporation's common stock (R. 4, 10).

In 1945, when the corporation was insolvent,¹ Healy and Hartfield each received a salary of \$30,000 from the corporation. Each was on the cash receipts and disbursements basis and each in his 1945 income tax return included his \$30,000 salary in his individual income. They filed their 1945 returns and paid the tax shown to be due thereon on or about March 27, 1946. (R. 4, 9-10.) During 1945 the corporation also paid insurance premiums on the lives of Healy and Hartfield in the amounts of \$1,131.25 and \$1,044.20, respectively.² (R. 5, 10.)

Upon examination of the corporation's 1945 return, the Commissioner determined that \$10,000 of the salary paid to each taxpayer and the life insurance premiums paid for taxpayers constituted excessive compensation and disallowed such payments as deductions. Disallowances were also made for portions of the salaries paid in the years 1941, 1942 and 1943, and for 1943 the Commissioner also disallowed as excessive compensation payments of life insurance premiums for taxpayers' benefit.³ The disallowances as to 1945, together with several other minor adjustments, merely resulted in reducing the corporation's net loss for that year from \$45,232.75 to \$21,741.29. (R. 5, 10.) The disallowances as to 1941, 1942 and 1943 re-

¹ The corporation's balance sheets as of December 31, 1944 and 1945, are a part of the stipulated facts. (R. 6.) The 1944 balance sheet shows assets of \$82,911.49 as against liabilities of \$81,592.73 and the 1945 balance sheet shows assets of \$72,201.46 as against liabilities of \$98,709.66.

² The corporation paid no dividends during 1945. (R. 6, 11.)

³ The record does not reveal the date or dates on which any of these determinations and disallowances were made.

sulted in the following deficiencies in tax and interest (R. 5, 10):

| Year | Income tax | Excess profits tax | Interest |
|------------|------------|--------------------|-----------|
| 1941 | \$1,523.64 | \$ 1,882.37 | \$ 476.14 |
| 1942 | 420.02 | 20,360.01 | 3,100.06 |
| 1943 | 221.07 | | 11.63 |

The application of the net loss carry-back based upon the corporation's adjusted net loss for 1945 resulted in the elimination of the 1942 and 1943 income tax deficiencies and interest thereon and reduced the 1942 excess profits tax deficiency (R. 5, 10-11), leaving unpaid by the corporation the following deficiencies in tax and interest (R. 5, 11):

| Year | Income tax | Excess profits tax | Interest |
|------------|------------|--------------------|------------|
| 1941 | \$1,523.64 | \$1,882.37 | |
| 1942 | | 6,525.31 | \$1,465.33 |

On December 31, 1947, each taxpayer advanced \$5,250 to the corporation to be used to pay the remaining income and excess profits tax deficiencies and interest. On the same day the corporation paid \$9,931.32 out of those funds to the Collector of Internal Revenue at Buffalo, New York, in partial satisfaction of the deficiencies. On December 24, 1948, each taxpayer paid \$715.37 to the Collector of Internal Revenue at Buffalo in satisfaction of the balance due from the corporation on the deficiencies.⁴ (R. 5-6, 11.) Thus, each taxpayer paid a total of \$5,681.03 on the tax deficiencies of the corporation.

⁴The record contains no explanation for the discrepancy between the total amount of the deficiency taxes and interest (\$11,396.65) and the total amount paid. (\$11,362.06).

The Commissioner determined income tax deficiencies for 1945 against each taxpayer, based upon a determination that the life insurance premiums paid by the corporation in that year for their benefit constituted taxable income to them. Taxpayers subsequently filed petitions for review with the Tax Court in which they questioned that determination and also alleged overpayments of their individual 1945 income taxes on the ground that the portions of their 1945 salaries determined by the Commissioner to be excessive as reasonable compensation, and disallowed as deductions to the corporation, did not constitute taxable income to them. (R. 9.) It was later stipulated that the insurance premiums were properly included by the Commissioner in their incomes as additional compensation for 1945. (R. 7.)

The Tax Court held that the 1945 income tax liability of each taxpayer should be recomputed by excluding from the compensation he received and reported in 1945 the amount which he actually paid on the corporation's tax deficiencies in 1947 and 1948 (\$5,681.03 as to each taxpayer).⁵ (R. 11-13.) The Court of Appeals reversed (R. 15-19).

⁵ While taxpayers each advanced the corporation \$5,250 on December 31, 1947, for payment on the corporation's deficiency taxes and each taxpayer on December 24, 1948, paid \$715.37 directly to the Collector on the corporation's deficiency taxes, the amount actually paid by each in satisfaction of the corporation's deficiency taxes was but one-half of the \$9,931.32 which the corporation paid from the total advances of \$10,500, plus the \$715.37 paid by each taxpayer directly to the Commissioner, or a total of \$5,681.03 as to each taxpayer.

SUMMARY OF ARGUMENT

With slight but immaterial variations in the facts, this case involves the same question as *Commissioner v. Hall C. Smith*, now pending before the Court (No. 138, October Term, 1952). These taxpayers received salary in the taxable year 1945 which they reported in their individual income tax returns. Having received the salaries under claim of right and without restriction as to disposition, they are each taxable in 1945 on the full amount of the salaries. Their argument to the contrary, like that of Hall C. Smith, is based upon their alleged transferee liability for the deficiency taxes of their corporation—a liability which was nonexistent until the time subsequent to 1945 when the Commissioner determined that taxpayers' 1945 salaries were in excess of reasonable compensation. The consequential payments by the taxpayers of the corporation's tax deficiencies are immaterial under the "claim of right" doctrine, as we show in our brief in the *Smith* case. For that reason there is also no merit in the taxpayers' additional argument that the corporation's payments of excessive compensation to them constituted void transfers under New York law, for that argument is similarly directed toward establishing, on the basis of determinations made subsequent to 1945, that taxpayers' receipt of their 1945 salaries was attended by a liability to pay over a portion thereof in a later year.

ARGUMENT

The Entire Amount of Salary Received by Each Taxpayer from the Corporation in 1945 is Taxable in that Year Even Though Taxpayers Subsequently Became Subject to Transferee Liability and Paid the Tax Deficiencies of the Corporation

This case, like *Commissioner v. Hall C. Smith*, now pending before the Court (No. 138, October Term, 1952), involves the applicability of the "claim of right" doctrine as related to transferee liability. Unlike the Sixth Circuit in the *Smith* case, the Second Circuit in the instant case regarded the applicability of the "claim of right" doctrine as beyond question and rejected taxpayers' contention that their individual 1945 income tax liabilities should be recomputed by excluding from their 1945 gross incomes the \$5,681.03 each paid in 1947 and 1948 on the corporation's tax deficiencies of prior years. (R. 15-17.) The decision is clearly correct. This case requires consideration apart from the *Hall C. Smith* case only because of a slight variation in basic facts and additional contentions advanced by taxpayers.

- A. *It is not open to taxpayers to contend that they did not receive the full amounts of their 1945 salaries in 1945.*

Inconsistently, taxpayers disclaim any intention of attempting to raise a new issue or advance a new theory but seek to demonstrate that the decision below is incorrect (Br. 16) through a contention which they now make for the first time (Br. 14-15). The contention evidently arises from the stipulated

fact (R. 5) that *cash* payment of taxpayers' salaries of \$30,000 was made partly in 1945 and partly on March 30, 1946. Taxpayers "concede that it must be assumed" that they each received a note in 1945 covering the balance of their 1945 salaries (\$16,875.90 as to Healy and \$16,821 as to Hartfield, both after deduction of withholding tax of \$5,042.70) and that the notes constituted payment to the extent of their fair market value, but contend that the notes had a combined fair market value of not more than \$7,188.70 as against face value of \$33,696.90.⁶ (Br. 15.) Obviously, this constitutes a contention that they did not receive the full amount of their 1945 salaries in 1945.⁷

Taxpayers have no standing to advance such a contention. In the petitions for review filed by them in the Tax Court (see original record, p. 2 of the petitions), each alleged that "During that year [1945] taxpayer received from the corporation as salary the amount of \$30,000". The answers filed by the Commissioner (Original record, p. 2 of the answers) admitted that "during 1945" each taxpayer "received" from the corporation "salary in the amount of \$30,000". Taxpayers made no request to amend their petitions and at no time until

⁶ Treasury Regulations 111, promulgated under the Internal Revenue Code, Section 29.22(a)-4, provide that—

Notes or other evidences of indebtedness received in payment for services constitute income to the amount of their fair market value. * * *

See also, *Schlemmer v. United States*, 94 F. 2d 77 (C.A. 2d).

⁷ Application of the "claim of right" doctrine in the present case is of course limited to the income received by taxpayer in 1945, the taxable year.

now have they attempted to dispute the above-mentioned allegations in their petitions. The decisions of the Tax Court and Court of Appeals, as well as taxpayers' petition for a writ of certiorari, were all based on the assumption that each taxpayer received the full amount of his 1945 salary in 1945.⁸ It is a well settled rule that allegations in the pleadings are admissions against the party making them and, unless withdrawn or amended, are binding. *Northern Pacific Railroad v. Paine*, 119 U. S. 561; *Scott v. Commissioner*, 117 F. 2d 36, 40 (C.A. 8th); *Sinclair Refining Co. v. Tompkins*, 117 F. 2d 596, 598 (C.A. 5th). Having admitted in their Tax Court petitions that they received the full amount of their 1945 salaries in 1945, taxpayers cannot now be heard to contend the contrary.

If it nevertheless be assumed that the contention

⁸ The Tax Court stated in its findings of fact (R. 10) that—

Each petitioner included in his individual income tax return for 1945 the \$30,000 received as salary, * * * and as follows in its opinion (R. 11-12):

Petitioners contend that the excessive salaries which they received from the corporation in 1945 are not includable in their incomes because * * *

Respondent contends that the full amount of the salaries received in 1945 is includable in petitioners' incomes * * *. (Italics supplied.)

The summary of facts contained in the opinion of the Court of Appeals includes the following (R. 15):

In 1945 the corporation was insolvent. During that year there was paid by the corporation as salary to each of the above named officers the sum of \$30,000. * * *

In their petition for a writ of certiorari taxpayers quoted the Court of Appeals' summary of the facts, including the above (p. 2); and stated the question presented as being related to compensation "received by the petitioners from an insolvent corporation in 1945" (p. 3).

is open to taxpayers, there is no justification for what seems to be a request by them (Br. 15) that this Court make an original determination on this record as to the fair market value of the notes. That is a factual issue, the original determination of which is for the Tax Court, and, moreover, since the issue was not even raised in the Tax Court, the record contains no evidence specifically directed to it. The only possible recourse, if the contention were open, would be a remand to the Tax Court for hearing and decision on the issue. A remand on a new issue is warranted only in extraordinary circumstances (*Hormel v. Helvering*, 312 U. S. 552, 555-560) and taxpayers do not contend that any unusual circumstance here exists.

This is not a case of hardship or possible injustice to taxpayers, for even the present record reflects that there is no merit in taxpayer's contention that the notes received by them had a total fair market value of no more than \$7,188.70 at the time of receipt in December of 1945. The contention is based on nothing more than an erroneous assumption that the fair market value of the notes was that amount which would have been left for application on the notes if at the end of 1945 the corporation's assets had all been converted into cash and all other liabilities paid. No reason is even given by taxpayers for the assumption that other liabilities as of the end of 1945 were entitled to preference over the notes as of that time. That the fair market value of the notes was equivalent to their face value is reflected by three facts of

record—(1) that taxpayers, who were on the cash receipts and disbursements basis, reported the full amounts of their 1945 salaries in their 1945 income tax returns (R. 10), despite payment of portions of the salaries in notes; (2) that the corporation, which was also on a cash basis (see the corporation's income tax return for 1945, Ex. 3, p. 3, of the original record), claimed deductions in 1945 for payment of the full amounts of the salaries (R. 5, 10); and (3) that the full amounts of the salaries paid in notes (\$16,875.90 as to Healy and \$16,821 as to Hartfield, both after deduction of withholding tax) were actually paid to taxpayers in *cash* on March 30, 1946 (R. 5), three months after receipt of the notes.

B. Taxpayers' 1945 salaries are taxable in full in 1945 as having been received under claim of right and without restriction as to disposition

The "claim of right" doctrine—under which a taxpayer is taxable in the year of receipt on funds received under a claim of right and without restriction as to disposition—is as equally applicable here as in *Commissioner v. Hall C. Smith*, now pending before this Court (No. 138, October Term, 1952). As we show in our brief in that case, the test of claim of right and without restriction as to disposition is a practical, as distinguished from a legal, test. That this test was met in the present case would seem necessarily to follow, as the court below thought (R. 17), from the fact that the full amount of the 1945 salary of each taxpayer

was reported on taxpayers' individual income tax returns for 1945 as earnings or income. There is, in any event, no evidence to rebut the conclusion that the full amount of the salary of each was received under claim of right and without any practical restriction as to disposition. The court below therefore correctly reversed the Tax Court's holding that taxpayers' 1945 income tax liabilities may be recomputed by excluding from the income of each the amounts he paid in 1947 and 1948 on the deficiency taxes of the corporation.

Taxpayer's contention to the contrary, like the contention of the taxpayer in the *Hall C. Smith* case, rests upon the trust fund doctrine of transferee liability. As we show in our brief in the *Hall C. Smith* case, such a contention simply amounts to an attempt to avoid the application of the "claim of right" doctrine by pointing to the ultimate determination in a later year that the taxpayers' original receipt of salary payments was subject to a liability on the part of the recipients to turn over the amount of the salary (or, as in this case, a portion thereof). The discussion here will be limited to demonstrating that the difference in facts as between the two cases is of no particular importance and to a brief answer of taxpayers' specific arguments.

We do not consider that these taxpayers are in any better position than Mr. Hall Smith merely because they voluntarily paid the deficiency taxes of the corporation without awaiting and contesting

determinations of transferee liability against them.⁹ Transferee liability in both cases necessarily depended upon a determination or determinations made subsequent to the taxable year. In voluntarily accepting transferee liability, taxpayers abandoned their claims of right to portions of their salaries for the taxable year earlier than did Mr. Smith, but that is immaterial so long as the salaries were received under claim of right during the taxable year.

Taxpayers are incorrect in asserting (Br. 14) that "at the end of 1945" they were under "an existing liability" for federal income taxes of an insolvent corporation. It is transferee liability upon which they rely for their argument that they were liable for taxes of the corporation, and in 1945 there was presumably no reason even to suspect that they were liable as transferees. They could not be held liable as transferees unless they received money or property from the corporation without consideration, and the determination that they had—implicit in the Commissioner's determination that their 1945 salaries were excessive—was not made until subsequent to 1945. It is immaterial that trans-

⁹ We do not contend that taxpayers are in any worse position because they in effect conceded transferee liability. In applying the "claim of right" doctrine, the courts have drawn no distinction between a concession and an adjudication of liability. See *Penn v. Robertson*, 115 F. 2d 167 (C.A. 4th); *Griffin v. Smith*, 101 F. 2d 348 (C.A. 7th), certiorari denied, 308 U. S. 561; *St. Regis Paper Co. v. Higgins*, 157 F. 2d 884 (C.A. 2d), certiorari denied, 330 U. S. 843; and *National City Bank of New York v. Helvering*, 98 F. 2d 93 (C.A. 2d).

feree liability, when determined, relates back to the time of receipt under the equitable theory of a constructive trust, as we show in our brief in the *Smith* case. It is also immaterial that perhaps only one determination constituting a condition precedent to transferee liability was made in the present case subsequent to the taxable year, whereas in the *Smith* case there were three such necessary determinations. Transferee liability did not exist in the taxable year in the absence of even one determination crucial to transferee liability. It may be noted, however, that the amount of taxes of the corporation actually paid by taxpayers, and for which they are claiming transferee liability, also was not determined until subsequent to 1945.¹⁰ As the court below stated (R. 17):

The liability of the taxpayers as transferees must necessarily have awaited the determination as to the existence and amount of the excessive salary payments. It was not fixed in 1945. Even though corporate insolvency were

¹⁰ Taxpayers' liability as transferees depended not only on a determination that their 1945 salaries were excessive, but upon a determination by the Commissioner that the corporation owed additional taxes for prior years. The record does not reveal whether the latter determination was made prior to the end of 1945. Assuming that it was, still it was not until after 1945 that the amount of taxes of the corporation actually paid by taxpayers was determined. The corporation's deficiencies for prior years were reduced by a carry-back of the corporation's net loss for 1945, the amount of which was not determined until the Commissioner adjusted the corporation's return for 1945, and it was the amount of the corporation's deficiencies for prior years as reduced by the carryback which taxpayers paid in 1947 and 1948 and which they are contending should be deducted from their 1945 incomes.

admitted, the liability of the officers did not exist until excessive payments were determined as a fact, and it was established that a deficiency in the corporate tax existed. * * *

There is no merit in taxpayers' argument that application of the "claim of right" doctrine is precluded because all of the events from which their transferee liability results, including the unreasonableness of their 1945 salaries, relate to and must be determined as of the year 1945 (Br. 8-9), even though "discovery may come in a later year" (Br. 9). It is the fact that discovery came in a later year which permits the conclusion that they received the full amounts of their 1945 salaries under claim of right and without restriction as to disposition. The determination of the existence of conditions precedent to transferee liability subsequent to 1945 on the basis of the facts as of 1945 merely goes to the fact of the ultimate defeat of the taxpayers' right to portions of their 1945 salaries, which, as we show in our brief in the *Hall C. Smith* case, is immaterial. A single illustration may be mentioned here. In *United States v. Lewis*, 340 U. S. 590, the taxpayer was held taxable in the year of receipt on the full amount of salary he received that year, despite a subsequent determination that the salary had been erroneously computed in the taxable year and that, therefore, he was required to return a portion of it.

It does not aid taxpayers to argue (Br. 11) that payment of excessive compensation by an insolvent corporation constitutes a void transfer under Sec-

tion 15 of the Stock Corporation Law of the State of New York (McKinney's Consolidated Laws of New York, Ann., Art. 3, Sec. 15). That argument, like the argument as to transferee liability, rests upon the Commissioner's determination subsequent to 1945 that taxpayers' 1945 salaries were in excess of reasonable compensation. A claim that the receipt of money constituted a void transfer does not preclude application of the "claim of right" doctrine. See *St. Regis Paper Co. v. Higgins*, 157 F. 2d 884 (C.A. 2d), certiorari denied, 330 U.S. 843 (dividends received from wholly owned subsidiary alleged to be void payments as in violation of trust indenture executed by declaring corporation); *Penn v. Robertson*, 115 F. 2d 167 (C.A. 4th) (money received under stock purchase plan allegedly void under state law); *Griffin v. Smith*, 101 F. 2d 348 (C.A. 7th), certiorari denied, 308 U.S. 561 (bonuses allegedly received under unauthorized directors' resolution). In the present case taxpayers have not even shown the existence of conditions precedent to liability under the New York statute. The statute applies only to payments made with the intent of giving preference to creditors (*New York Credit Men's Ass'n v. Hasenberg*, 26 F. Supp. 877 (S.D.N.Y.), affirmed *per curiam*, 107 F. 2d 1020 (C.A. 2d), certiorari denied, 309 U.S. 666) and taxpayers do not even assert that the payments were made with such an intent. Whether liability under the statute could or could not have been established against taxpayers, the fact remains that they received the entire

amount of their 1945 salaries under claim of right and without any practical restriction as to disposition. Cf. *Rutkin v. United States*, 343 U. S. 130.

This case illustrates the incongruity of reliance upon the trust fund doctrine of transferee liability (as well as upon the asserted voidability of the payment of excessive compensation under New York law) as a bar to application of the "claim of right" doctrine. The trust fund doctrine of transferee liability (as well as the New York statute) applies to the entire excessive portion of each taxpayer's 1945 salary, whereas taxpayers are claiming only that part of the excessive portions of their 1945 salaries (the \$5,681.03 each paid on the tax deficiencies of the corporation) should be excluded from their 1945 incomes. This points up the fact that transferee liability, when based on a determination or determinations made subsequent to the taxable year, has significance only as being the reason for abandonment, subsequent to the taxable year, of the claim of right. It does not dissipate the controlling fact—receipt in the taxable year under claim of right and without practical restriction as to disposition.

CONCLUSION

The decision below is correct and should be affirmed.

Respectfully submitted,

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DECEMBER, 1952.

